KHK Advertising Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri

HIGH COURT (KUALA LUMPUR) — CIVIL APPEAL NO R1–14–4 OF 1999
KC VOHRAH J
15 NOVEMBER 2000

Revenue Law *— Income tax — Deduction — Leave passage provided to directors of company — Leave passage was part of remuneration package for employees — Whether services of employees contributed to production of gross income — Whether deductible — Income Tax Act 1967 s 33(1) & 39*

At a hearing before the special commissioners of income tax, the appellant appealed against additional assessments in respect of the years of assessment 1984 to 1987 under the Income Tax Act 1967 ('the Act'). The appellant had provided leave passage to two of its directors. The sole issue for determination of the special commissioners was whether the cost of leave passage provided by the appellant to its directors was an expense wholly and exclusively incurred in the production of gross income of the appellant for the years of assessment 1984 to 1987 and deductible under s 33(1) of the Act and not prohibited from deduction under s 39 of the Act. The Act was amended in 1988 effective from the year of assessment 1989 where free leave passages are restricted as a deduction under s 39(1)(m). The special commissioners decided that the cost of leave passage was not allowable deduction under s 33(1) of the Act and dismissed the appeal. Hence, the appeal by the appellant to the court to determine on the same issue.

Held, allowing the appeal with costs:

(1) The special commissioners were erroneous on a point of law when they in relation to the deductibility of expenses for leave passage incurred by the employer for the employee under s 33(1) of the Act, addressed it as an issue as to how the employee spent the compensation and not whether the leave passage was part of the remuneration package in respect of the services rendered. It was not whether the leave passage contributed to the production of income. It was whether the services rendered by the employees contributed towards the production of gross income. Free leave passage was the reward for the services rendered (see pp 183H, 185C–D).

(2) Had they addressed the right question, they would have come to the conclusion that the services provided by the employees was in production of gross income for which the free leave passage was paid (see p 185D-E). Moreover, the amendment to the Act in 1988 does indicate that only precise words can deny a deduction which would otherwise be deductible (see pp 183I–184A).

[Bahasa Malaysia summary

Di pembicaraan di hadapan pesuruhjaya-pesuruhjaya khas cukai pendapatan, perayu telah merayu terhadap taksiran tambahan berhubung dengan tahun-tahun taksiran 1984 hingga 1987 di bawah Akta Cukai Pendapatan 1967 ('Akta tersebut'). Perayu telah menyediakan 'leave passage' kepada dua pengarahnya. Satu-satunya isu untuk diputuskan oleh pesuruhjaya-pesuruhjaya khas adalah sama ada kos 'leave passage' yang disediakan oleh perayu kepada pengarah-pengarahnya merupakan suatu perbelanjaan yang ditanggung secara keseluruhan dan eksklusif dalam hasil pendapatan kasar perayu untuk tahun-tahun taksiran 1984 hingga 1987 dan boleh ditolak di bawah s 33(1) Akta tersebut dan tidak dilarang daripada tolakan di bawah s 39 Akta tersebut. Akta tersebut dipinda pada tahun 1988 mulai tahun taksiran 1989 yang mana 'leave passages' percuma adalah dihadkan sebagai suatu tolakan di bawah s 39(1)(m). Pesuruhjaya-pesuruhjaya khas memutuskan bahawa kos 'leave passage' bukan merupakan tolakan yang dibenarkan di bawah s 33(1) Akta tersebut dan menolak rayuan tersebut. Maka rayuan dibuat oleh perayu kepada mahkamah untuk memutuskan isu yang sama.

Diputuskan, membenarkan rayuan tersebut dengan kos:

(1) Pesuruhjaya-pesuruhjaya khas terkhilaf atas suatu hujah undang-undang apabila mereka, berkenaan dengan tolakan perbelanjaan untuk 'leave passage' yang ditanggung oleh majikan di bawah s 33(1) Akta tersebut, menumpukan perhatian kepada isu mengenai bagaimana pekerja membelanjakan pampasan itu dan tidak sama ada 'leave passage' itu adalah sebahagian daripada pakej ganjaran berkaitan dengan khidmat yang diberikan. Isu bukanlah sama ada 'leave passage' tersebut telah menyumbang kepada hasil pendapatan. Isu adalah sama ada khidmat yang diberikan oleh pekerja-pekerja telah menyumbang terhadap hasil pendapatan kasar. 'Leave passage' percuma merupakan ganjaran untuk khidmat yang diberikan (lihat ms 183H, 185C–D).

(2) Andainya mereka telah menjawab persoalan yang betul, maka pesuruhjaya-pesuruhjaya khas akan mencapai kesimpulan bahawa perkhidmatan yang disediakan oleh pekerja-pekerja adalah dalam menghasilkan pendapatan kasar yang mana 'leave passage' percuma itu telah dibayar (lihat ms 185D–E). Apatah lagi, pindaan kepada Akta tersebut pada tahun 1988 menunjukkan bahawa hanya perkataan-perkataan yang tepat sahaja boleh menafikan satu tolakan yang sebaliknya boleh ditolak (lihat ms 183I–184A).

Notes

For cases on deduction for income tax, see 10 *Mallal's Digest* (4th Ed, 1999 Reissue) paras 2021–2056.

Cases referred to

Ampat Tin Dredging Ltd v DGIR [1982] 2 MLJ 49 (refd)
CIR v Europa Oil (NZ) Ltd [1971] NZLR 641 (refd)
Edwards v Bairstow & Harrison [1956] AC 14 (refd)
Lower Perak Co-operative Housing Society Bhd v KPHDN [1994] 2 MLJ 713 (refd)
Ralli Estates Ltd v CIT [1961] 1 WLR 329 (refd)
Saledy Sdn Bhd v DGIR [1995] 2 MSTC 31440 (refd)
Strick v Regent Oil Co Ltd [1966] AC 295 (refd)
Vallambrosa Rubber Co Ltd v Farmer STC 529 (refd)

Legislation referred to

Income Tax Act 1967 ss 33(1), 39, (1)(m)

Dr Arjunan Subramaniam (*Geraldine Yeoh, Arjunan & Associates*) for the appellant.

Abu Tariq bin Jamaluddin (Inland Revenue Board of Malaysia) for the respondent.

KC Vohrah J. : At a hearing before the special commissioners of income tax, KHK DMB & B SDN BHD appealed against four notices of additional assessment all dated 17 March 1993 issued by the director general of inland revenue in respect of the years of assessment 1984 to 1987 under the Income Tax Act 1967.

The sole issue for the determination of the special commissioners was:

> Whether the cost of leave passage provided by the appellant to its directors is an expense wholly and exclusively incurred in the production of gross income of the appellant for the years of assessment 1984 to 1987 and deductible under s 33(1) of the Act, and not prohibited from deduction under s 39 of the Act.

The appellant had provided leave passage to two of its directors Kok Hong Kung ('KHK') and Lim Keng Chuan ('LKC').

The special commissioners were 'of the unanimous opinion that the cost of leave passage incurred in respect of KHK and LKC are not allowable deductions under s 33(1) of the Act and dismissed the appeal and confirmed the additional assessments on the appellant.

In the appeal before this court, the sole issue that was before the special commissioners is the same sole issue for consideration.

The appellant was known as KHK Needham Standard Sdn Bhd, but in 1989 it was changed to KHK Standard Sdn Bhd. Then, in 1991, it took the name of KHK DMB & B Sdn Bhd and finally in October 1997, it became known as KHK Advertising Sdn Bhd.

The appellant, a private limited company incorporated on 5 May 1972, carried on the business of advertising, designing contracts and film production.

On 8 March 1983, the appellant, then known as KHK Needham Standard Sdn Bhd, entered into service agreements with three of its

directors, namely, KHK, LKC and one Cheng Sin Po. The service agreements, provided, among other terms, leave passage for the directors and their families, once in every two complete years of service, to a country or countries of their choice.

Pursuant to this term in the service agreements, the appellant incurred the leave passages in respect of its Malaysian directors in the years 1983, 1984, 1985 and 1986 and claimed deduction as expenses incurred under s 33(1) of the Act for the years of assessment 1984 to 1987. Revenue disallowed the cost of the leave passages in respect of KHK and LKC and raised additional assessments for the years of assessment 1984 to 1987.

The provision under which the deductions are claimed, s 33(1), reads as follows:

> Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including …

Certain deductions are disallowed. The provision, s 39, which disallows such deductions reads :

> (1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of — …
>
> (b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of producing the gross income; …
>
> (m) notwithstanding subparagraph (i) of paragraph (1), any expenditure incurred in the provision of a benefit or amenity to an employee consisting of a leave passage within or outside Malaysia.

It has to be noted that s 39(1)(m) prohibiting 'expenditure incurred in the provision of a benefit or amenity to an employee consisting of a leave passage within or outside Malaysia' applies as from the year of assessment 1989.

To put it briefly, s 33(1) deals with deductions which are allowed while s 39(1) refers to deductions which are not allowed.

The short argument of the appellant before the special commissioners and also before this court is this. The expenditure incurred for leave passages should be allowed unless prohibited by s 39. There was no prohibition in s 39 save for the provision relating to the prohibition from the year of assessment 1989 which does not cover the years of assessment 1984 to 1987 claimed herein. Thus all compensation paid, such as free leave passage prior to the year of assessment 1989, was incurred wholly and exclusively in the production of gross income under s 33(1) and the proper question to address is whether the services provided by the employees were

in the production of gross income for which compensation which included the free passage was paid.

Revenue argued that each of the air passages was 'private and vacational' as a term of the contract of service between the appellant and each of the two directors. The terms of each contract of service do not determine the deductibility of the payments made to the said director. Being 'private and vacational', the cost of each leave passage is not wholly and exclusively incurred in the production of gross income under s 33(1) of the appellant. Revenue relied on the principle in the High Court case of *Saledy Sdn Bhd v DGIR* [1995] 2 MSTC 31440 decided by Harun J (as he then was):

> To qualify for deductions under s 33 of the Act, the expenses must be wholly and exclusively incurred in connection with the production of gross income of the taxpayer. The fact that the expenses is contractual is irrelevant for tax purposes. Being private and vacational, the expense clearly cannot be both wholly and exclusively incurred in connection with the production of gross income of the appellant. The expense there is caught by s 33 read with s 39(1)(b) of the Act.

The special commissioners were obviously influenced by the *Saledy* case — they said they were bound by the High Court decision — and concluded that 'the cost of leave passages of KHK and LKC are not allowable deductions under s 33(1) of the Act …'

Their reasoning leading to their conclusion was based on the acceptance of revenue's arguments that the cost of the leave passages are not allowable under s 33(1) of the Act.

The special commissioners in analyzing s 33(1) had this to say:

> The first three conditions, namely, 'outgoings and expenses', 'wholly and exclusively' and 'incurred in that period', are not in dispute. The crux of the appeal centres on one issue only, ie whether the expenses incurred, was 'in the production of gross income.' …
>
> Considering the private and vacational nature of the leave passages to a country or countries chosen by the directors, it certainly cannot be said to be in the production of gross income. 'There must be a good connection between the expenditure incurred and the earning of the income of the trade.' (Malaysian Tax Reporter — Vol 1 at p 8145).
>
> …
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> The appellant submitted that in view of s 13(1)(b)(ii) of the Act, which recognises leave passage as employment income, it follows that such expenditure should be given deduction. It must be noted that the character of an expenses is not determined by the nature of the receipt in the hands of the recipient.

The above last sentence is a statement of principle, relying on *Ralli Estates Ltd v CIT* [1961] 1 WLR 329 and *Strick v Regent Oil Co Ltd* [1966] AC 295, but as with any principle what matters is not what the principle states but how it is applied.

To continue with the special commissioners' reasoning:

A Considering the private and vacational nature of the leave passages to a country or countries chosen by the directors, it certainly cannot be said to be in the production of gross income. There must be a good connection between the expenditure incurred and the earning of the income of the trade (The Malaysian Tax Reporter, Vol 1 at p 8145).

B With respect to the special commissioners, the wrong issue was raised. They should have addressed the issue as to what compensation (salary, benefits in kind, free leave passage) was given for the services rendered.

The special commissioners laid emphasis on how the employees spent their compensation. Compensation, of course, can be in cash or kind. The point is that free leave passage was one of the components of the salary C package. Does it matter that the employee visited countries of his choice? Does that mean that the employer did not incur the expense? This illustrates the error into which the learned special commissioners fell.

It was not disputed that the employees' services were in the production of income. Hence their compensation must be deductible under s 33 D Income Tax Act 1967. With respect, the learned special commissioners' reference to excerpts from the Malaysian Tax Reporter are out of context.

The special commissioners have stressed that it is not the intention of the legislature to make all contractual payments tax deductible and that is certainly an unexceptional statement of the law, but that does not exempt E the special commissioners from determining the proper issue as to what was the compensation given for services rendered.

It is with great regret that I cannot therefore agree with what was stated in the *Saledy* case that '… being private and vacational, the expense clearly cannot be wholly and exclusively incurred in the production of gross income …' With respect, how an employee expended his compensation paid by the F employer was not in issue. To make a distinction that may have escaped some, if an employee claims a deduction from his salary the cost of a private trip abroad, then that is private and vacational. It is not so where the claim by an employer for compensation agreed for services rendered is a benefit in kind.

G I turn to another point where in relation to s 33(1) of the Act '… expenses wholly exclusively incurred … in the production of gross income …' where the special commissioners stated that the appellant had failed to show that the cost of the leave contributed to the production of income.

H My view is that this is an indication of a misdirection by the learned special commissioners. It is not whether the leave passage contributed to the production of income. It is whether the services rendered by the employees contributed towards the production of gross income. Free leave passage was the reward for the services rendered; free leave passage was a cost to the employer in respect of services rendered.

I The Act was amended by Act 364 of 1988 effective from the year of assessment 1989, where free leave passages were restricted as a deduction under s 39(1)(m). What this means is that compensation paid to employees

> The appellant's argument that the expenditure was debited to the profit and loss accounts of the appellant, and that for tax purposes the expense is said to be incurred, is untenable because whether an expenditure or loss is an allowable deduction from gross income is not influenced by the way the taxpayer has treated the outgoing in his accounts. The Inland Revenue Department is still entitled to see for what the expenditure or loss was incurred — (Malaysian Tax Reporter — Vol 1 at p 8203).

Reference was also made to the case of *CIR v Europa Oil (NZ) Ltd* [1971] NZLR 641 for the principle enunciated, but again what matters is how it is applied.

The special commissioners then went on to state:

> Considering the above, there is no way the expenses in respect of the leave passage can be said to be incurred in the production of gross income as envisaged in s 33(1) of the Act. The expenses also is 'not money wholly and exclusively laid out or expended for the purpose of producing the gross income' and therefore not an allowable deduction by virtue of s 39(1)(b) of the Act.

They then 'rejected the appellant's arguments that the leave passage being a contractual term found in the service agreement, is beyond the powers of the (Revenue) to disregard' and then latched on to the *Saledy* case as stated earlier.

Then relying on the case of *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 49 where the principle is that to qualify for deduction under s 33(1), it is not sufficient that the money incurred is related to the production of income but it must be wholly and exclusively incurred on the production of income, they held that 'while the leave passage can be said to be related to the production of income but mostly not exclusively in the production of income as required by s 33(1) of the Act.' They were also of the view that the appellant 'apart from showing it, did incur the expense during the period and that it was contractual, failed to show that the cost of leave passage contributed to the production of income.'

It will be remembered that s 39(1) was amended to prohibit from the year of assessment 1989, deductions for leave passage. The appellant had contended that with the amendment it seemed to indicate that prior to the coming into force of the amendment such leave passage was an allowable deduction.

The special commissioners rejected the contention.

> We are of the view that any amendment to s 39(1) does not usurp the operation of s 33(1) of the Act. The fact remains that the expenditure even if not prohibited by s 39, despite s 39(1)(b) which, we feel, is prohibitory enough, must go through the test of in the production of gross income in s 33(1) of the Act.

It will be seen that uppermost in the deliberations of the special commissioners was how the employees spent their compensation for their services and not whether the leave passage was part of the remuneration package in respect of the services rendered as is manifest in their statement:

in the form of free passages are restricted. The amendment does indicate that only precise words can deny a deduction which would otherwise be deductible.

At one part of the decision of the special commissioners there is a reference to the *Saledy* case decided at the level of the special commissioners before it went up on appeal. This is what was stated:

> Therefore, allowing expenses merely because they are incurred by the taxpayer and/or that they are contractual not only 'amounts to absurdity' as described by the special commissioners in *Saledy* (1985) MTC 50, but also in our view, it would be a mockery of s 33(1) of the Act in particular, and the taxing statutes in general. In such an event, every conceivable expenditure will then become deductible just because it is a term of a contract. …
>
> As such, the expenditure in respect of the leave passage does not survive the test as required in s 33(1) of the Act.

Here again, the learned special commissioners have misdirected themselves in focusing on whether the leave passage produced gross income instead of directing themselves as to whether the services provided produced the gross income for which the leave passage is a reward to the employees, and a cost incurred in producing the gross income, the cost being the total compensation, including the leave passage paid to the employees.

It is generally accepted that the phrase 'in the production of gross income' means that the expenditure incurred need not produce income in the same year. In fact, an expenditure incurred may not produce income but may lead to a loss. In *Vallambrosa Rubber Co Ltd v Farmer* STC 529, this principle that expenditure need not produce income in the same bass period is explained as follows:

> We find from your own admission that at present in this year, only a seventh of your rubber trees are in full bearing, and therefore, they say, we shall hold that only one-seventh of these expenses can be expenses of the ordinary business and as such deductible, and that the other six-sevenths are not deductible. Now, that somewhat startling result was before your Lordships argued on two grounds. The junior counsel for the Crown, encouraged by certain expressions which he found used by various learned judges who had given judgments in Tax Cases, wished your Lordships to accept this proposition, that nothing ever could be deducted as an expense unless that expense was purely and solely referable to a profit which was reaped within the year. I think that proposition has only to be started to be defeated by its own absurdity.

At any rate, the question is not how remuneration paid for work performed in producing gross income is spent by the individual employee. As has been pointed out by counsel for the appellant, some employers even pay the employees cost of domestic servants and surely the domestic servant of an employee is not producing gross income for the employer. The question is whether the employee's work is producing gross income for which he is paid in various ways including the cost of domestic servants.

The role of an appellate court in respect of a case stated has been spelt out by the Supreme Court in *Lower Perak Co-operative Housing Society Bhd*

v KPHDN [1994] 2 MLJ 713, which adopted the principles enunciated by Lord Radcliffe in *Edwards v Bairstow & Harrison* [1956] AC 14 at p 36:

> If the case contains anything ex facie which is bad law and which bears upon the determination, it is, obviously, erroneous in point of law. But, without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law. I do not think it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination.

It is quite clear that the special commissioners were erroneous on a point of law when they, in relation to deductibility of expenses for leave passage incurred by the employer for the employee under s 33(1) of the Act, addressed it as an issue as to how the employees spent the compensation and not whether the leave passage was part of the remuneration package in respect of the services rendered. It is clear that had they addressed the right question they would have come to the conclusion that the services provided by the employees was in production of gross income for which the free leave passage was paid.

The appeal is therefore allowed with costs.

Appeal allowed with costs.

Reported by Moy Saw Han